

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer	Chair
Marshall Johnson	Commissioner
Ken Nickolai	Commissioner
Thomas Pugh	Commissioner
Phyllis A. Reha	Commissioner

In the Matter of Minnesota Power's Petition for Approval of an Amendment to Affiliated Interest Agreement with Split Rock Energy, LLC, and Taconite Harbor Requested Change in Price Index and Soft Cap

ISSUE DATE: February 2, 2005

DOCKET NO. E-015/AI-04-353

In the Matter of Minnesota Power's Petition for Approval of Affiliated Interest Agreements and Purchase of Transmission Facilities from Rainy River-Taconite Harbor

DOCKET NO. E-015/AI-01-1648

In the Matter of Minnesota Power's Petition for Approval of Intra-Company Transfer of Taconite Harbor Electric Generation Station and Associated Assets from Rainy River Energy Corporation-Taconite Harbor to Minnesota Power

DOCKET NO. E-015/AI-01-1988

ORDER APPROVING AMENDED AGREEMENT AND MODIFICATIONS TO TACONITE HARBOR PRICING

PROCEDURAL HISTORY

On February 2, 2004, Minnesota Power (MP) filed its required annual report listing those instances where Taconite Harbor energy was used to serve retail customers of MP in lieu of more expensive market energy purchases.¹ In its report, in anticipation of its February 1, 2004 withdrawal from Split Rock Energy LLC (Split Rock), MP requested that: a) the Taconite Harbor

¹ As required in Docket No. E-015/AI-01-1648, *In the Matter of Minnesota Power's Petition for Approval of Affiliated Interest Agreements and Purchase of Transmission Facilities from Rainy River-Taconite Harbor* and Docket No. E-015/AI-01-1988, *In the Matter of Minnesota Power's Petition for Approval of Intra-Company Transfer of Taconite Harbor Electric Generation Station and Associated Assets from Rainy River Energy Corporation-Taconite Harbor to Minnesota Power*, ORDER ACCEPTING COMPLIANCE FILING WITH MODIFICATIONS (September 17, 2002).

allocations be treated as 95% of MP's average purchase price, rather than Split Rock's average purchase price; and b) the current \$45/MWh soft cap be increased to a \$60/MWh hard cap, which would limit any allocation to that amount. As an alternative MP requested that the soft cap be set at \$60/MWh.

On March 2, 2004, MP filed a petition for approval of an amendment to the Wholesale Power Coordination and Dispatch Operating Agreement, an affiliated interest agreement between MP and Split Rock.² The amendment provides for MP to withdraw from the Split Rock Partnership but provides that MP and GRE will continue with MAPP joint reporting through Split Rock. MP requested approval of this amendment from the effective date of MP's withdrawal from Split Rock (February 1, 2004) until the withdrawal is approved by the Federal Energy Regulatory Commission (FERC) and there is no longer an affiliated relationship between MP and Split Rock.

On April 1, 2004, MP filed a copy of FERC's March 10, 2004³ Order approving MP's formal withdrawal from Split Rock.

On June 24, 2004, the Department of Commerce (DOC) filed comments recommending, among other things, that: a) the Commission approve the proposed amendment to the Agreement, b) MP address in its August 2004 Resource Plan concerns for the need for firm generation, c) MP address in its next rate case the issue of whether Taconite Harbor is a regulated asset used for retail customers or a non-regulated asset, and d) the Commission approve an index for the Taconite Harbor Generating Plant of the lesser of 95% of MP's average purchase price for on-peak hours not to exceed a \$50/MWh hard cap.

On June 24, 2004, the Residential and Small Business Utilities Division of the Office of the Attorney General (RUD-OAG) filed comments recommending, among other things, that MP be required to charge regulated customers a cost-based price for Taconite Harbor power.

On July 9, 2004, MP filed reply comments.

On July 13, 2004, Blandin Paper Company, Hibbing Taconite Joint Venture, Ispat Inland Mining Company, Sappi Fine Paper North America, Stora Enso, United States Steel Corporation and United Taconite, LLC (collectively, Large Power Interveners) filed joint reply comments.

On January 13, 2005, this matter came before the Commission.

² Split Rock was the limited liability company formed by MP and Great River Energy (GRE) for the purpose of combining power supply assets and customer load service requirements for power pool operations. MP has chosen to withdraw from Split Rock effective February 1, 2004, subject to Federal Energy Regulatory Commission (FERC) approval.

³ ORDER AUTHORIZING DISPOSITION OF JURISDICTIONAL FACILITIES, Docket No. EC04-60-000, issued March 10, 2004.

FINDINGS AND CONCLUSIONS

I. Background

A. Regarding the Agreement Between Split Rock and MP

Split Rock was formed in 2000 by MP and Great River Energy (GRE) in order to combine power supply assets and customer load service requirements for power pool operations. Split Rock provided generation control and load dispatching services to each member company. MP and GRE assigned load dispatching and scheduling functions, including MAPP responsibility, to Split Rock.⁴

B. Regarding the Taconite Harbor Facility

The transfer of the Taconite Harbor Electric Generating Station, formerly belonging to LTV Steel Mining Company, to MP was approved by the Commission on June 11, 2002.⁵

As a result of the transfer, the LTV generation assets were to be included within MP, a regulated entity, but would be operated as an unregulated facility. The Commission, because of concerns with a regulated entity purchasing power from an unregulated generator, required a compliance filing that detailed the services and products exchanged between the regulated operations and the unregulated generation. Further, the Commission required that the filing also address the circumstances in which power would be purchased and describe the pricing mechanism to be applied.

MP's compliance filing⁶ set forth conditions that MP instituted to ensure that the use of Taconite Harbor would be reasonable for ratepayers. They include:

- a) MP will discount the Taconite Harbor price to 95% of the amount that would have been paid through Split Rock energy in order to reflect lower transmission costs.
- b) The maximum price at which the Taconite Harbor energy would be assigned to MP

⁴ The Wholesale Power Coordination and Dispatch Operating Agreement between MP and Split Rock was approved by the Commission on June 1, 2000 in Docket No. E-015/AI-00-322.

⁵ *In the Matter of Minnesota Power's Petition for Approval of Intra-Company Transfer of Taconite Harbor Electric Generation Station and Associated Assets from Rainy River Energy Corporation-Taconite Harbor to Minnesota Power*, Docket No. E-015/AI-01-1988, ORDER APPROVING PETITION WITH MODIFICATIONS (June 11, 2002).

⁶ Accepted by the Commission in ORDER ACCEPTING COMPLIANCE FILING WITH MODIFICATIONS, September 17, 2002.

retail (fuel clause) customers would be capped at \$45/MWh average for on-peak hours. When market prices are expected to exceed the average, Taconite Harbor energy would not be dispatched to retail load. When prices are expected to be below average, Taconite Harbor energy could be dispatched.

c) Taconite Harbor would be dispatched for retail customer usage for no more than 50% of its total annual generation capability, excluding when used to meet outages on MP's system and when Taconite Harbor is used for specific Large Power customer transactions.

II. MP's Petition

A. Regarding the Amendment to the Agreement Between Split Rock and MP

MP requested approval for an amendment to the Wholesale Power Coordination and Dispatch Operating Agreement between MP and Split Rock to reflect MP's withdrawal from Split Rock, effective February 1, 2004.⁷ Split Rock will continue to operate under GRE's ownership and control as GRE's agent for power marketing and brokering. Under the amended agreement MP and GRE will continue joint MAPP reporting through Split Rock. However, GRE and MP are discontinuing the use of Split Rock as the joint entity for energy sourcing and energy marketing activities.

As a result of its decision to withdraw from Split Rock, MP has re-established its energy supply operations in-house to manage the Company's energy requirements, and to manage short-term energy purchasing and sales to cover surplus or deficit situations. Further, MP has exited the business of power trading in order to reduce risk exposure.

MP stated that the amended agreement would be an affiliated interest agreement only from February 1, 2004 through the date FERC approved MP's withdrawal from Split Rock. MP argued that after that time the agreement, as amended, will continue but will no longer be an affiliated interest agreement.

MP argued that the amendment to the Wholesale Power Coordination and Dispatch Operating Agreement between Split Rock and MP provides for the withdrawal of MP while maintaining the benefits of power coordination to meet end-use load obligations and the benefits of MAPP joint reporting.

B. Regarding Taconite Harbor Pricing

As a result of MP's exit from Split Rock and considering the increasing regional wholesale energy prices, MP proposed, in its 2004 compliance filing, two changes to the Taconite Harbor energy allocation method that was previously established by the Commission.

First, MP proposed changing the allocation price methodology from one based on the average market energy price determined by Split Rock purchases to one based on an average market

⁷ MP's withdrawal was approved by FERC on March 10, 2004, Docket No. E-C04-60-000.

energy price determined by MP purchases. MP proposed this since MP reestablished its energy supply purchasing operation upon its withdrawal from Split Rock and MP would now be the entity participating in the wholesale transactions.

Second, due to the recent increases in energy market prices, MP proposed an increase in the \$45/MWh soft cap to a \$60/MWh hard cap, which would limit any allocation to that amount, rather than allowing actual on-peak prices to carry the allocation price higher, as is currently allowed at the \$45/MWh allocation price under a soft cap.

MP stated that the benefit of the allocation of Taconite Harbor energy for general retail (fuel clause) customer purposes was that it reduced the amount of energy MP otherwise purchased in the wholesale market to meet retail customer energy requirements. This limited allocation of energy from Taconite Harbor to MP retail customers utilized the periods of excess or available Taconite Harbor energy to reduce the fuel clause impact on retail customers at those times when MP would otherwise be purchasing energy in the wholesale market. However, MP argued, the current soft cap of \$45/MWh limited an allocation to its retail customers at the exact time that Taconite Harbor was the most cost-effective source of energy from a price and delivery perspective.

III. Positions of the Parties

A. DOC

1. Regarding the Amendment to the Agreement between Split Rock and MP

The DOC recommended that the Commission approve the Amended Wholesale Power Coordination and Dispatch Operating Agreement between MP and GRE. The DOC considered the changes to be reasonable and in the public interest.

2. Regarding Taconite Harbor Energy

The DOC stated its concern that there has been a greater need by retail and large power customers for purchases from the Taconite Harbor plant than originally anticipated. The DOC questioned whether MP may have a need for firm generation and expressed concern about MP's recent trend of having to make spot purchases in the market to serve retail customers.

Because of these concerns, the DOC recommended that MP address these issues in its August 24, 2004 Resource Plan, including why Taconite Harbor shouldn't be considered a low cost resource used to serve retail customers in the future. Further, the DOC recommended that MP should address in its next rate case the issue of whether Taconite Harbor is a regulated asset used for retail customers or a non-regulated asset.

The DOC stated it supported MP's request for an index for the Taconite Harbor Generating Plant of the lesser of 95 percent of MP's average purchase price for on-peak hours but recommended

that this not exceed a \$50MWh hard cap. The DOC argued that it supported this hard cap because it would result in a fixed and reasonable cost for ratepayers while ensuring that MP would get a reasonable level of cost recovery for its generation plant.

Finally, the DOC recommended that the Commission approve the conditions below that were previously approved in the Commission's September 17, 2002 Order, modified to reflect changes recommended by the DOC. MP would be required to:

- document bids to ensure Taconite Harbor is the lowest cost alternative for retail customers;
- ensure that at least one bid is from a non-affiliate of MP;
- provide an explanation for the circumstances and supporting evidence that market prices exceeded the \$50/MWh level, when MP exceeds the \$50 MWh hard cap;
- report prices charged to Large Power customers for use of Taconite Harbor;
- recognize ongoing regulatory authority over the rates and transactions of Taconite Harbor which could require that MP's ratepayers pay only an imputed cost-based rate for purchases from Taconite Harbor if circumstances warrant such an approach;
- restrict Taconite Harbor use to 50 percent of total generating capacity for retail customers, excluding when used to meet outages on MP's system and when Taconite Harbor is used for specific Large Power customers' transactions.

B. RUD-OAG

The RUD-OAG argued that MP's proposal to use market based rates rather than cost-based rates for power produced at its Taconite harbor plant and allocated to its retail customers is precluded by state law, and would amount to unauthorized deregulation of retail electric rates.

RUD-OAG argued that because MP is providing power from its own plants, it should provide such power at cost-based rates to its retail, native-load customers. By using market based rates, RUD-OAG argued, MP's retail customers could be required to pay more than the actual cost plus a reasonable rate of return.

The RUD-OAG recommended that the Commission require MP to discontinue selling Taconite Harbor power at market rates and require the imputation of cost-based rates. Further, the RUD-OAG recommended that if the Commission continues to allow the sale of Taconite Harbor power to retail customers at market rates the Commission should find that such allocations are affiliate interest transactions and cap the prices.

C. Large Power Intervenors

The Large Power Intervenors⁸ agreed that the average of Split Rock purchase prices should be replaced with an average of MP purchased prices in the formula to determine the fuel surcharge to be paid by MP retail customers.

The Large Power Intervenors also stated that it should be clarified that the average peak price in the formula should be the average of the “day ahead” energy prices being quoted to MP one day before the purchase, and MP’s price should be fixed at 95% of that number.

Further, regarding the cap proposed by MP, the Large Power Intervenors argued that there was no good reason to limit the sales with an artificial cap and that the cap should be removed from the formula in its entirety. They argued that such a cap acts to take Taconite Harbor off the table at the very times it is most needed to keep retail rates down.

D. Minnesota Power

A. Regarding the Amendment to the Agreement between Split Rock and MP

MP agrees with the DOC’s recommendation that the Petition to amend MP’s affiliated interest agreement with Split Rock be accepted. MP stated that the petition should be approved irrespective of the decision in the Taconite Harbor matter.

B. Regarding Taconite Harbor Energy

MP stated that the benefit of the allocation of Taconite Harbor energy applicable to retail customers is that it reduces the amount of energy MP otherwise purchases in the wholesale market to meet retail customer energy requirements. MP argued that it was not required to allocate energy from Taconite Harbor to its retail customers but this was undertaken because it provides some benefit in reducing fuel clause costs to customers.

MP argued that the allocation methodology may continue as set forth in MP’s proposal or may be terminated if the RUD-OAG view that rates were unreasonable when tied to a market based indicator was accepted. In that case MP would cease allocating energy to its retail customers and continue to sell Taconite Harbor energy in the wholesale market. MP argued that the cost-based approach recommended by the RUD-OAG would only be applicable if MP were seeking to rate-base the Taconite Harbor facility, which it is not.

⁸ Large power interruptible customers purchase power from Taconite Harbor under the Rider for Large Power Interruptible Energy. In the current docket there are no proposals to change the way Taconite Harbor power is purchased for purposes of this Rider.

IV. Commission Action

A. Regarding the Amendment to the Agreement between Split Rock and MP

The Commission will approve the Amended Wholesale Power Coordination and Dispatch Operating Agreement between MP and Split Rock. The amended agreement provides for MAPP joint reporting, continued coordination of shared control areas between MP and GRE, and shared MAPP fees. This amended agreement is consistent with the public interest in that it allows for efficient use of MP's and GRE's generating resources and MAPP membership to serve Minnesota end-use customers.

B. Regarding Taconite Harbor Energy

The Commission will also approve MP's proposal to change the allocation price methodology from one based on the average market energy price determined by Split Rock purchases to one based on an average market energy price determined by MP purchases. Under this proposal Taconite Harbor allocations would now be treated as 95 percent of MP's average purchase price.

This change is appropriate given that MP has reestablished its energy supply purchasing operation, that MP is now the entity making purchases in the marketplace for MP retail customers and that the substitution of MP's purchase price for Split Rock's does not change the allocation process originally approved.

The Commission continues to be concerned about the charges to ratepayers when MP holds the Taconite Harbor facilities within MP for wholesale purposes and also sells to general ratepayers at market rates. In order to address its concerns the Commission will accept the DOC's recommendation that the index for the Taconite Harbor Generating Plan be capped at a \$50/MWh hard cap. The Commission finds that the \$50MWh hard cap is a reasonable short-term solution.

The Commission recognizes that the question of whether MP may need additional firm generation resources to meet the needs of its retail customers, rather than having to buy on the spot market during peak times at high costs, must be further addressed. The appropriate forum to do so is MP's 2004 Resource Plan, which has been submitted to the Commission for review, and the Commission will require that MP address this at that time.

Further, the issue of whether Taconite Harbor should be a regulated asset used to serve retail customers or a non-regulated asset should be addressed in MP's next rate case.

By requiring that these issues be addressed in MP's 2004 Resource Plan and in its next rate case, and requiring the \$50MWh hard cap as a reasonable interim solution, the Commission's concerns and the concerns of the DOC and the RUD-OAG have been addressed. For this reason, the Commission finds it is not necessary to act on the RUD-OAG's recommendation that MP be required to charge cost-based rates or its recommendation that MP and Taconite Harbor transactions be subject to the affiliated interest statute.

Previous conditions set forth by MP and accepted by the Commission in its September 17, 2002

ORDER ACCEPTING COMPLIANCE FILING WITH MODIFICATIONS, updated to reflect the changes set forth herein, remain in effect.

Finally, the Commission clarifies that the action taken by the Commission herein is the result of unusual circumstances regarding MP's acquisition of Taconite Harbor and the Commission does not consider it precedent for future plant acquisitions.

ORDER

1. The Commission hereby approves the Amended Wholesale Power Coordination and Dispatch Operating Agreement.
2. The Commission hereby approves an index for Taconite Harbor pricing for retail uses of the lesser of 95 percent of MP's average purchase price for on-peak hours not to exceed a \$50/MWh hard cap.
3. MP shall address the issue of MP's potential need for firm generation and MP's trend to make spot market purchases in MP's current resource plan, including why Taconite Harbor shouldn't be considered a low cost resource used to serve retail customers in the future.
4. MP shall address the issue of whether Taconite Harbor is a regulated asset used for retail customers or a non-regulated asset in MP's next rate case.
5. MP shall document day ahead market prices to show eligibility of Taconite Harbor allocations. At least three price quotes shall be from a non-affiliate of MP.
6. When MP exceeds the \$50/MWh hard cap, MP shall provide an explanation of the circumstances and supporting evidence that market prices exceeded the \$50/MWh hard cap.
7. MP shall report the prices charged to Large Power customers for use of Taconite Harbor energy.
8. MP shall recognize ongoing regulatory authority over the retail rates and retail transactions of Taconite Harbor, which could require that MP's ratepayers pay only an imputed cost-based rate for purchases from Taconite Harbor if circumstances warrant such an approach.
9. MP shall restrict the use of Taconite Harbor for retail customers, excluding when used to meet outages on MP's system and when Taconite Harbor is used for Large Power customers' transactions, to 50 percent of total generating capacity.
10. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

This document can be made available in alternative formats (i.e., large print or audio tape) by calling (651) 297-4596 (voice), or 1-800-627-3529 (MN relay service).